Case No. D7/89

Appeals – accounts of taxpayer – alleged mistake – need for clear and strong evidence.

Assessments – 'error or omission' – need to introduce evidence as to the alleged mistake – s 70A of the Inland Revenue Ordinance.

Profits tax – pre-incorporation losses – whether these could be taken into account in computing a company's post-incorporation profits.

Panel: William Turnbull (chairman), Della P H Chan and Andrew Halkyard.

Date of hearing: 23 February 1989.
Date of decision: 17 April 1989.

The taxpayer company was incorporated in July 1983. The promoters of the company had carried on business from May 1983 and had incurred losses in the pre-incorporation period.

The taxpayer's first profits tax return included audited accounts and a tax computation for the period which commenced on the date of the taxpayer's incorporation and which therefore did not take into account the pre-incorporation losses.

The IRD refused to allow the pre-incorporation losses to be taken into account in computing the post-incorporation profits of the company. The taxpayer appealed. It claimed that the profits tax return and the audited accounts of the company were incorrect because they did not take into account the pre-incorporation losses.

Held:

The company was not entitled to the benefit of the pre-incorporation losses.

(a) As a matter of general law, a company cannot ratify contracts concluded prior to its incorporation. (Section 32A of the Companies Ordinance, which permits such ratification, was not enacted at the relevant times.) Nor could there have been a novation of the relevant contracts on the facts, because the contracts were executed and not executory.

(b) In any case, there was in fact no ratification by the taxpayer of the pre-incorporation acts. This was evident from the fact that the first set of

audited accounts of the taxpayer did not incorporate the pre-incorporation acts. These accounts are evidence of what the parties thought and intended at the relevant time, and they showed that the taxpayer had not purported to ratify events which had occurred prior to its incorporation.

(c) Although accounts might be incorrect, there must be clear and strong evidence before the Board will conclude that such an accounting error has been made. There was no such evidence in this case.

(d) For a claim to be successful under section 70A, there must be some evidence as to what mistake has allegedly been made.

Appeal dismissed.

Wong Chi Wah for the Commissioner of Inland Revenue.
Stanley So of Stanley So & Co for the taxpayer.

Decision:

This appeal is by a taxpayer, a limited company, against a determination refusing to accept an application made under section 70A of the Inland Revenue Ordinance to change a tax assessment for the year of assessment 1983/84.

The facts are as follows:

1. The Taxpayer was a limited company incorporated in Hong Kong in July 1983.

2. The Taxpayer was incorporated by promoters who commenced business in May 1983, prior to the date on which the Taxpayer was incorporated. The reason given for this was that the promoters were in a position to commence business prior to the legal formalities being completed for the incorporation of the Taxpayer. However, notwithstanding the fact that the Taxpayer had not been incorporated, the business was carried on under the Chinese name of the Taxpayer.

3. For reasons not known, the Taxpayer was not issued with and did not file any tax return for the year 1983/84 in the usual way. However, a tax return was issued to the Taxpayer in respect of the year of assessment 1984/85. This tax return was duly filed by the Taxpayer on 28 August 1985 and accompanying it were the audited accounts of the Taxpayer for the period from 8 July 1983 (the date of incorporation) up to 31 December 1984. In addition, the Taxpayer submitted two computations of assessable profits or losses, one in respect of the period from 7 May 1983 up to 7 July 1983. This computation was headed with

the name of the Taxpayer in English and immediately thereunder the description 'unincorporated business'. It stated that the business commenced on 7 May 1983 and ceased on 7 July 1983 and that losses had been incurred. The second computation was likewise in the name of the Taxpayer but did not make any reference to its business being either incorporated or unincorporated and was for the period from 8 July 1983 up to 31 December 1983. It stated that the business commenced on 8 July 1983.

4. A tax assessment was issued to the Taxpayer in respect of the year of assessment 1983/84 even though no tax return had been submitted by the Taxpayer. It would appear that the assessor had deemed it expedient so to do under the provisions of the proviso to section 59(1) of the Inland Revenue Ordinance, though no evidence as to this was given to the Board. It can be inferred from the fact that the assessor issued the assessment without a tax return having been filed that he was of the opinion that it was expedient to do so, otherwise he would not have done so. In the tax assessment for 1983/84, the assessor brought into assessment only the profits made by the Taxpayer for the period from the date of incorporation to 31 December 1983 and disregarded the losses of the 'unincorporated business'. This was in accordance with the audited accounts of the Taxpayer and with the second tax computation submitted by the Taxpayer.

5. On the face of the tax assessment, the assessor included an endorsement requesting the Taxpayer to file a tax return in the following words: 'Profits per computation please complete the attached profit tax return for record'.

6. The Taxpayer proceeded to file this tax return on 28 October 1985. The tax return was in accordance with the assessment which had already been issued, that is, the amount of assessable profits disclosed therein was the same as the amount of the assessment which had already been issued.

7. On 2 August 1983, the directors of the Taxpayer passed a resolution in the following terms:

> ' It was resolved:
>
> THAT the working & profit & loss account of the company for the period from 7 May 1983 to 7 July 1983 as tabled, be ratified and confirmed as the true and correct trading results of the company prior to the incorporation of the company on 8 July 1983.
>
> THAT Mr X being appointed as representative to collect the trade debts for and on behalf of the company before the bank accounts were opened be ratified and approved unanimously'.

8. Prior to the incorporation of the Taxpayer, and contemporaneous with the transactions taking place, accounts of the unincorporated business were maintained and these accounts were continued by the Taxpayer after its incorporation.

9. In the audited accounts of the Taxpayer submitted with the tax return on 28 August 1985, the Taxpayer showed the losses previously sustained by the unincorporated business as being goodwill which it had acquired.

10. Subsequently, the Taxpayer decided that the audited accounts, tax computations and tax return previously filed were incorrect and that the Taxpayer should be deemed to have been carrying on business with effect from 7 May 1983 or otherwise should be entitled to the benefit of the losses which had been incurred by the unincorporated business.

Two questions arise from this appeal. One is a technical question as to whether or not, if a mistake had been made, it is a mistake which is capable of being rectified under section 70A of the Inland Revenue Ordinance. The second question is the substantive one, namely, whether a mistake was made. It is convenient to deal with this second question first.

The burden of proof is upon the Taxpayer to show that a mistake was made. It must show that the assessment which it wishes to have changed was incorrect. At the hearing of the appeal, the Taxpayer was represented by its tax representative who submitted documentary evidence to us which included extracts from certain books of account. No witness was called to explain the extracts.

The Taxpayer's representative asked us to disregard the tax computations which had been filed by the Taxpayer on 28 August 1985. The submission was made that these computations were not binding on the Taxpayer because the Taxpayer, when filing its tax return for the year of assessment 1984/85, had not intended to enter into any legal arrangement with the Commissioner in respect of the preceding tax year, 1983/84. It was further submitted that the audited accounts were not binding in respect of taxation matters and that the Taxpayer could reflect a transaction in its audited accounts in one way but have it treated for tax purposes in another way. We were also asked to disregard the tax return for the year 1983/84 which was filed by the Taxpayer after the issue of the assessment because this was only to conform with the assessment. It was submitted that the Taxpayer or the Taxpayer's management had not realised that the assessment was incorrect when it was issued and that, for that reason, no appeal was lodged within the statutory period of one month.

The representative for the Commissioner submitted, among other things, that the Companies Ordinance had been amended subsequent to the relevant events to permit a company to ratify transactions carried out in its name prior to its incorporation (section 32A of the Companies Ordinance). The representative pointed out that this provision was not in

existence at the relevant time and drew our attention to the law on agency which did not permit a company to ratify transactions which had been conducted in its name prior to its incorporation.

We appreciate that neither of the two representatives who appeared before us was legally qualified and that neither was in a position to give us an exhaustive review of the law relating to companies and pre-incorporation transactions. It appears to us that the Commissioner's representative's submission was correct and that a transaction made in the name of a non-existent party cannot be binding on that party. A company cannot, as a matter of general law, ratify contracts concluded before its incorporation. The legal effect is that those who have made the contracts will be personally liable under those contracts. A company after incorporation may purport to 'ratify' a transaction but the legal effect can only be one of novation. In the case before us novation is not applicable because the contracts were executed and not executory. What the Taxpayer is now seeking to do is to have the profit or loss of completed contracts included in its accounts. This does not seem to us to be possible. However, it is not necessary for us positively to answer this question as to whether or not a company can or cannot take over pre-incorporation transactions because of the view which we take of the facts of this appeal.

On the facts before us and as a matter of fact, we find that the Taxpayer did not take over the pre-incorporation contracts or business transactions. We have two conflicting sets of facts. One is that the Taxpayer is alleged to have included in its accounts the transactions which took place before its incorporation and to have passed a resolution purporting to ratify pre-incorporation transactions. The other is the audited accounts, tax computations and tax return prepared by the Taxpayer. We are of the opinion that the latter are of more substance than the former.

As mentioned, the substantive question is whether or not the Taxpayer was carrying on a trade or business prior to the date of its incorporation and whether or not the losses suffered during such period could be and were brought to account by the Taxpayer for profits tax purposes. The simple answer to this question is that it did not do so.

The representative for the Taxpayer submitted that the tax computations filed by the Taxpayer with the Commissioner, the tax return and the audited accounts could all either be disregarded or explained. With due respect, we cannot agree with this. Whilst it is true to say that the accounting treatment and audit of accounts does not change the nature of a business transaction for taxation purposes, it is clear evidence of what the parties thought and intended at that time. It needs strong and clear evidence to show that what has been written and recorded is incorrect. We have no such evidence.

It is not necessary for us to decide whether or not the Taxpayer, as a matter of law, could or could not have ratified and taken over the transactions which occurred prior to its incorporation. The simple fact of the matter is that the Taxpayer did not do so. It may well be that the Taxpayer was advised or thought that it was not entitled to take over such transactions as if they were its own. That is not for us to speculate. We are left with the

simple situation that the Taxpayer commenced its business on the day of its incorporation, that is, 8 July 1983. On that day it acquired a previously conducted business and showed the losses which that business had incurred as goodwill. This indicates that the Taxpayer considered those losses to be of a capital nature and not as part of its own trading results.

Having decided as a matter of fact that the Taxpayer did not treat the pre-incorporation business as part of its on-going business, it is not necessary for us to decide the technical question of whether or not this appeal would have come within the provisions of section 70A of the Inland Revenue Ordinance. However, we do note that there was no evidence brought before us as to what was the mistake which it was alleged had been made. Some interesting arguments and submissions were made by the two representatives who appeared before us but it is not necessary or appropriate for us to deal with them.

For the reasons given, we dismiss this appeal.